

ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon. Such term shall not, however, include mineral, oil, or gas royalty interests, such as a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply. The term "interest in real property" also shall include options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(8) *Interest in a commodity.* The term *interest in a commodity* shall include the ownership and co-ownership of any type of personal property other than a security, and any leaseholds thereof. Such term shall include mineral, oil, and gas royalty interests, including any fractional undivided interest therein. Such term also shall include any put, call, straddle, option, or privilege on any type of personal property other than a security.

(9) *Value.* The term *value* shall mean, with respect to investments for which market quotations are readily available, the market value of such investments; and with respect to other investments, fair value as determined in good faith by the managers of the segregated asset account.

(10) *Terms used in section 851.* To the extent not inconsistent with this paragraph (h) all terms used in this section shall have the same meaning as when used in section 851.

(i) *Effective date.*—(1) *In general.* This section is effective for taxable years beginning after December 31, 1983.

(2) *Exceptions.* (i) If, at all times after December 31, 1983, an insurance company would be considered the owner of the assets of a segregated asset account under the principles of Rev. Rul. 81-225, 1981-2 C.B. 12, this section will not apply to such account until December 15, 1986.

(ii) This section will not apply to any variable contract to which Rev. Rul. 77-85, 1977-1 C.B. 12, or Rev. Rul. 81-225, 1981-2 C.B. 12, did not apply by reason of the limited retroactive effect of such rulings.

(iii) In determining whether a segregated asset account is adequately diversified for any calendar quarter ending before July 1, 1988, debt instru-

ments that are issued, guaranteed, or insured by the United States or an instrumentality of the United States shall not be treated as government securities if such debt instruments are secured by a mortgage on real property (other than real property owned by the United States or an instrumentality of the United States) or represent an interest in a pool of debt instruments secured by such mortgages.

(iv) This section shall not apply until January 1, 1989, with respect to a variable contract (as defined in section 817(d)) that (1) provides for the payment of an immediate annuity (as defined in section 72(u)(4)); (2) was outstanding on September 12, 1986; and (3) the segregated asset account on which it was based was, on September 12, 1986, wholly invested in deposits insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation.

[T.D. 8242, 54 FR 8730, Mar. 2, 1989; T.D. 8242, 54 FR 11866, Mar. 22, 1989]

§ 1.818-1 Taxable years affected.

Sections 1.818-2 through 1.818-8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6558, 26 FR 2785, Apr. 4, 1961 as amended by T.D. 7469, 42 FR 12181, Mar. 3, 1977]

§ 1.818-2 Accounting provisions.

(a) *Method of accounting.* (1) Section 818(a)(1) provides the general rule that all computations entering into the determination of taxes imposed by part I, subchapter L, chapter 1 of the Code, shall be made under an accrual method of accounting. Thus, the over-all method of accounting for life insurance companies shall be the accrual method. Except as otherwise provided in part I, the term "accrual method" shall have the same meaning and application in section 818 as it does under section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For general rules relating to the

taxable year for inclusion of income and deduction of expenses under an accrual method of accounting, see sections 451 and 461 and the regulations thereunder.

(2) Section 818(a)(2) provides that, to the extent permitted under this section, a life insurance company's method of accounting may be a combination of the accrual method with any other method of accounting permitted by chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. Thus, section 818(a)(2) specifically prohibits the use by a life insurance company of the cash receipts and disbursements method either separately or in combination with a permissible method of accounting. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. For purposes of section 818(a)(2), a life insurance company may elect to compute its taxable income under an over-all method of accounting consisting of the accrual method combined with the special methods of accounting for particular items of income and expense provided under other sections of chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. These methods of accounting for special items include the accounting treatment provided for depreciation (section 167), research and experimental expenditures (section 174), soil and water conservation expenditures (section 175), organizational expenditures (section 248), etc. In addition, a life insurance company may, where applicable, use the crop method of accounting (as provided in the regulations under sections 61 and 162), and the installment method of accounting for sales of realty and casual sales of personalty (as provided in section 453(b)). To the extent not inconsistent with the provisions of the Internal Revenue Code of 1954 or the regulations thereunder and the method of accounting adopted by the taxpayer pursuant to this section, all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual state-

ment approved by the National Association of Insurance Commissioners.

(3)(i) An election to use any of the special methods of accounting referred to in subparagraph (2) of this paragraph which was made pursuant to any provisions of the Internal Revenue Code of 1954 or prior revenue laws for purposes of determining a company's tax liabilities for prior years, shall have the same force and effect in determining the items of gross investment income under section 804(b) and the items of deduction under section 804(c) of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) as if such Act had not been enacted.

(ii) For purposes of determining gain or loss from operations under section 809(b), in computing the life insurance company's share of investment yield under section 809(b) (1)(A) and (2)(A), an election with respect to any of the special methods of accounting referred to in subparagraph (2) of this paragraph which was made pursuant to any provision of the Internal Revenue Code of 1954 or prior revenue laws, shall not be affected in any way by the enactment of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

(iii) For purposes of determining gain or loss from operations under section 809(b), in computing the items of gross amount under section 809(c) and the deduction items under section 809(d), an election to use any of the special methods of accounting referred to in subparagraph (2) of this paragraph must be made in accordance with the specific statutory provisions of the sections containing such elections and the regulations thereunder. However, where a particular election may be made only with the consent of the Commissioner (either because the time for making the election without the consent of the Commissioner has expired or because the particular section contained no provision for making an election without consent), and the time prescribed by the applicable regulations for submitting a request for permission to make such an election for the taxable year 1958 has expired, a life insurance company may make such an election for the year 1958 at the time of filing its return for that year (including extensions thereof). For example, a life

insurance company may elect any of the methods of depreciation prescribed in section 167 (to the extent permitted under that section and the regulations thereunder) with respect to those assets, or any portion thereof, for which no depreciation was allowable under prior revenue laws, for example, furniture and fixtures used in the underwriting department. Similarly, a life insurance company shall be permitted to make an election under section 461(c) (relating to the accrual of real property taxes) with respect to real property for which no deduction was allowable under prior revenue laws. Any such election shall be made in the manner and form prescribed in the applicable regulations.

(iv) For purposes of subdivision (ii) of this subparagraph, the method used under section 1016(a)(3)(C) (relating to adjustments to basis) in determining the amount of exhaustion, wear and tear, obsolescence, and amortization actually sustained shall not preclude a taxpayer from electing any of the methods prescribed in section 167 in accordance with the provisions of that section and the regulations thereunder for determining the amount of such exhaustion, wear and tear, obsolescence, and amortization for the year 1958. For example, if the amount of depreciation actually sustained, under section 1016(a)(3)(C), on a life insurance company's home office building (other than that portion for which depreciation was allowable under prior revenue laws) is determined on the straight line method, the life insurance company may elect for the year 1958 to use any of the methods prescribed in section 167 for determining its depreciation allowance for 1958. However, such election shall be binding for 1958, and for all subsequent taxable years, unless consent to change such election, if required, is obtained from the Commissioner in accordance with the provisions of section 167 and the regulations thereunder.

(4)(i) For purposes of section 805(b)(3)(B)(i) (relating to the determination of the current earnings rate for any taxable year beginning before January 1, 1958), the determination for any year of the investment yield and the assets shall be made as though the

taxpayer had been on the accrual method prescribed in subparagraph (1) of this paragraph for such year, or the accrual method in combination with the other methods of accounting prescribed in subparagraph (2) of this paragraph, if these other methods of accounting are used by the taxpayer in determining the investment yield and assets for the taxable year 1958. However, where the method used for determining the deduction under section 167 for the year 1958 differs from the method used in prior years, the amount of the deduction actually allowed or allowable for such prior years for purposes of section 1016(a)(2) (relating to adjustments to basis) shall be the amount to be taken into account in determining the current earnings rate under section 805(b)(3)(B)(i).

(ii) For purposes of section 812(b)(1)(C) (relating to operations loss carrybacks and carryovers for years prior to 1958), the determination for those years of the gain or loss from operations shall be made as though the taxpayer had been on the accrual method of accounting prescribed in subparagraph (1) of this paragraph for such year, or the accrual method in combination with the other methods of accounting prescribed in subparagraph (2) of this paragraph, if these other methods of accounting are used by the taxpayer in the determination of gain or loss from operations for the taxable year 1958. However, where any adjustment to basis is required under section 1016(a)(3)(C) on account of exhaustion, wear and tear, obsolescence, amortization, and depletion sustained, the amount actually sustained as determined under section 1016(a)(3)(C) for each of the years involved shall be the amount allowed in the determination of gain or loss from operations for purposes of section 812(b)(1)(C).

(b) *Adjustments required if accrual method of accounting was not used in 1957.* The items of gross amount taken into account under section 809(c) and the items of deductions allowed under section 809(d) for the taxable year 1958 shall be determined as though the taxpayer had been on the accrual method of accounting prescribed in paragraph (a) of this section for all prior years. Thus, life insurance companies not on

the accrual method for the year 1957 shall accrue, as of December 31, 1957, those items of gross amount which would have been properly taken into account for the year 1957 if the company had been on the accrual method described in section 818(a). Likewise, life insurance companies not on the accrual method for the year 1957 shall accrue, as of December 31, 1957, those items of deductions which would have been properly allowed for the year 1957 if the company had been on the accrual method described in section 818(a). For example, if certain premium amounts were received during the year 1958 but such amounts would have been properly taken into account for the year 1957 if the taxpayer had been on the accrual method for the year 1957, then the taxpayer will not be required to take such premium amounts into account for the year 1958. If, for example, certain claims, benefits, and losses were paid during the year 1958 but such items would have been properly taken into account for the year 1957 if the taxpayer had been on the accrual method for the year 1957, then the taxpayer will not be permitted to deduct such expense items for the year 1958. For a special transitional rule applicable with respect to changes in method of accounting required by section 818(a) and paragraph (a) of this section, see section 818(e) and § 1.818-6.

(c) *Change of basis in computing reserves.* (1) Section 806(b) provides that if the basis for determining the amount of any item referred to in section 810(c) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then for purposes of subpart B, part I, subchapter L, chapter 1 of the Code (relating to the determination of taxable investment income), the amount of such item shall be the amount computed on the old basis as of the close of the taxable year and the amount computed on the new basis as of the beginning of the next taxable year. Similarly, section 810(d)(1) provides rules for determining the amount of the adjustment to be made for purposes of subpart C, part I, subchapter L, chapter 1 of the Code (relating to the determination of gain or loss from operations), if the basis for deter-

mining any item referred to in section 810(c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year. Under an accrual method of accounting, a change in the basis or method of computing the amount of liability of any item referred to in section 810(c) occurs in the taxable year in which all the events have occurred which determine the change in the basis or method of computing the amount of such liability and, in which, the amount thereof (whether increased or decreased) can be determined with reasonable accuracy.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. Assume that during the taxable year 1960, M, a life insurance company, determines that the amount of its life insurance reserves held with respect to a particular block of contracts is understated on the present basis being used in valuing such liability and that such liability can be more accurately reflected by changing from the present basis to a particular new basis. Assume that M uses such new basis in computing its reserves under such contracts at the end of the taxable year 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine the change in basis and the amount of any increase (or decrease) attributable to such change can be determined with reasonable accuracy. Such change shall be treated as having occurred during the taxable year 1960 whether M determines that its liability under such contracts was understated for the first time during 1960, or that its liability under such contracts has, in fact, been understated for a number of prior years.

Example 2. Assume the facts are the same as in example 1, except that during the taxable year 1960 the insurance department of State X issues a ruling, pursuant to authority conferred by statute, requiring M to use the particular new basis which more accurately reflects its liability with respect to such contracts and that as a result of such ruling, M uses the new basis in computing its reserves under such contracts for the taxable years 1958, 1959, and 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine that a change in basis should be

made and the amount of any increase (or decrease) attributable to such change can be determined with reasonable accuracy.

[T.D. 6558, 26 FR 2785, Apr. 4, 1961]

§ 1.818-3 Amortization of premium and accrual of discount.

(a) *In general.* Section 818(b) provides that the appropriate items of income, deductions, and adjustments under part I, subchapter L, chapter 1 of the Code, shall be adjusted to reflect the appropriate amortization of premium and the appropriate accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. The adjustment for accrual of discount increases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. However, for taxable years beginning after May 31, 1960, only the accrual of discount relating to issue discount will increase the exclusion and reduction for wholly tax-exempt interest. See section 103.

(b) *Acquisitions before January 1, 1958.*

(1) In the case of any such security acquired before January 1, 1958, the premium is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, its then fair market value.

The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(2) The adjustments for amortization of premium and accrual of discount will be determined:

(i) According to the method regularly employed by the company, if such method is reasonable, or

(ii) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed "regularly employed" by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before made such adjustments, the company initiates in the first taxable year for which the adjustments are made a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter. Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(3) The method of amortization and accrual prescribed by this section is as follows:

(i) The premium (or discount) shall be determined in accordance with this section; and

(ii) The appropriate amortization of premium (or accrual of discount) attributable to the taxable year shall be an amount which bears the same ratio